DOW THEORY LETTERS INC.

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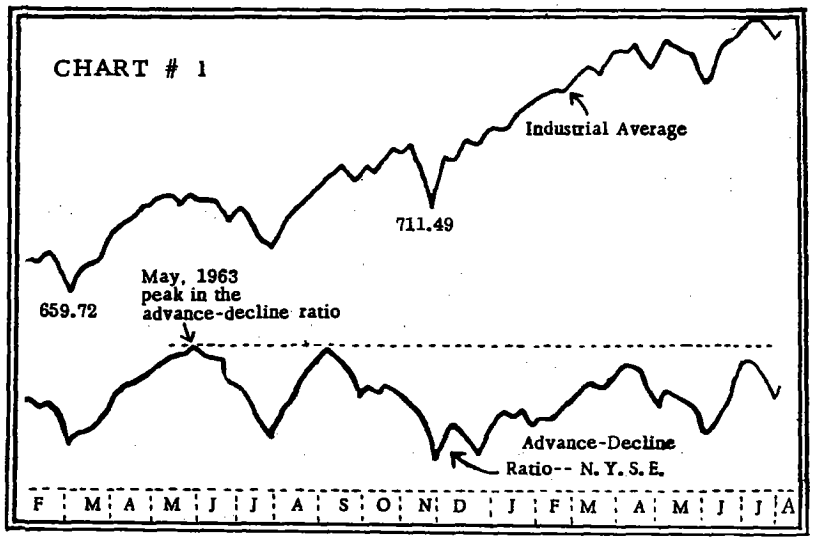
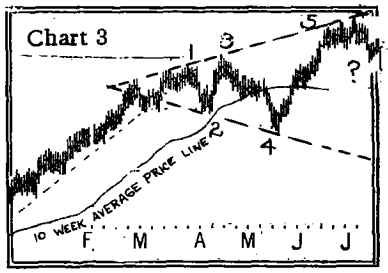
THE MARKET: The Vietnam crisis came (ironically) almost as a welcome event to many Wall Street analysts. Those who had been bullish (but who were becoming increasingly disturbed by the sloppy March-July action) used the crisis as an "all bets off" excuse ("after all, Wall Street is hardly supposed to be able to forecast Communist acts of aggression"). On the other hand, those who had been bearish used the crisis as an "I told you so" device, and they hastened to remind their followers that when stocks are "fundamentally and historically high", any emergency will serve to bring them down.

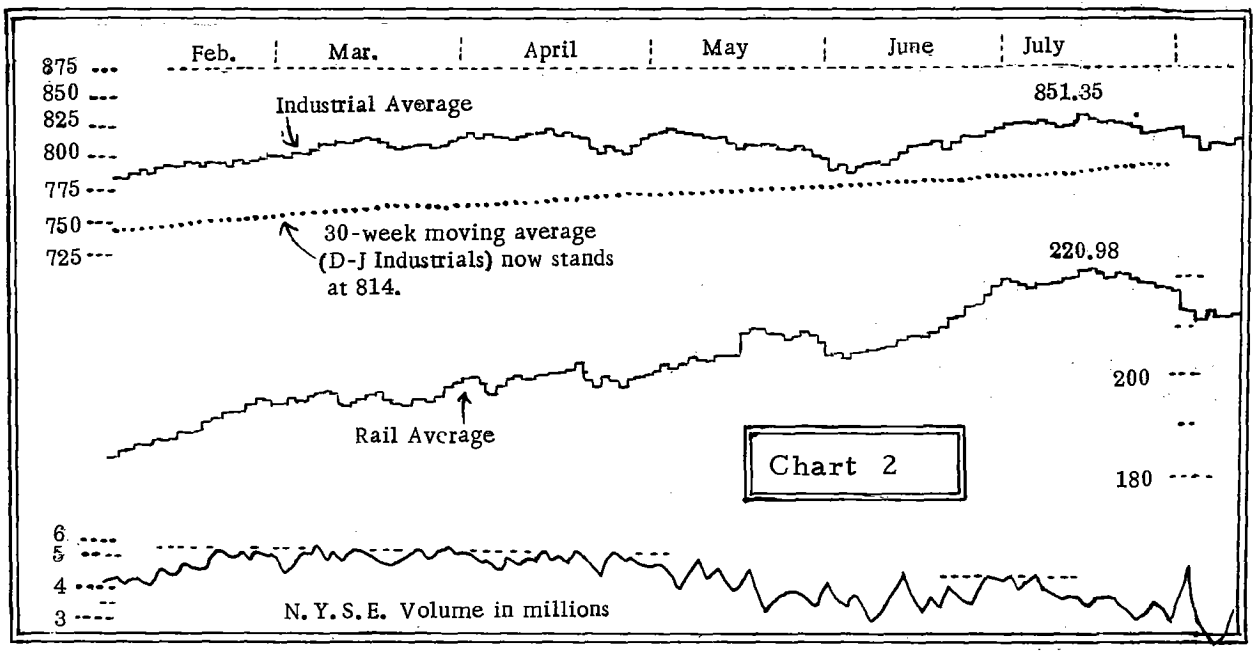
It is worth noting that the Averages actually turned down on July 17, two weeks before the Vietnam crisis, and following a June-July rally which was characterized by listless volume (see Letters 260 and 261). The Vietnam confrontation and the later Cypress trouble materialized at a time when the market was technically "out of breath" (and out of breadth) and seeking the safety of lower levels.

As a gauge of the possible action ahead, it is worth remembering that the Industrial Average has declined below its 30-week moving average (M. A.) on only two occasions since the 1962 lows. In July, 1963, Industrials dipped approximately 5 points below their M. A., the duration of that dip being 10 days. In November, 1963, the Industrial Average (on the day after President Kennedy's assassination) dropped approximately 15 points below its M. A.; this penetration lasted only one day. The M. A. now stands at 815, a level which will figure importantly in the event of any further decline. During major secondary reactions and bear markets, the senior Average drops below the M. A. and tends to stay below that indicator on almost all subsequent rallies and declines.





Readers are entitled to maintain a "wait and hope" attitude as long as the Industrial Average continues to hold above the M. A. Nevertheless, it is well to remember that: (1) The current action is taking place within the framework of a potential "broadening pattern" (chart 3), a formation which in the past has been associated with major weakness. (2) The advance-decline ratio has turned down from the same area (chart 1) which produced weakness on three



previous occasions. (3) Based on past pre-election performance (see next section), it would be normal for the market to establish a declining trend (with intermittent rallies) until some time in late-September to late-October.

From the standpoint of the impartial observer, the odds are: (A) that the Averages will not substantially better their July highs between now and election time; (B) that the market will show reactionary tendencies during most of August and September; (C) that there will be a buying opportunity (or at least a " trading buy-spot") between now and the end of October.

DAILY ACTION: Although the daily action can be deceptive, I usually apply a checklist to the daily statistics in an effort to gauge the strength or weakness of the situation. In a strong market, the two Averages advance together, volume expands with higher prices, daily new highs exceed new lows (the ratio of highs as against lows improves as the advance progresses), and there are consistently more daily advances than declines. As a further check, Standard & Poor's Averages tend to stay in step with the D-J Averages (multiply the S & P 425 Industrial Average's movement by 10, and it should then roughly equal the gain or loss in the D-J Industrial Average. During weak or deceptive rallies, there will seldom be a single day in which the market checks out on the above listing. During a strong bull movement, it is amazing how often the above list checks out satisfactorily.

ELECTION YEAR PATTERNS: While the foreign situation could produce important and unexpected market developments at any time, it is nevertheless worth noting that there has (in the past) been a pre-election pattern on Wall Street. The most important facet of the pre-election pattern is that it has produced a decline and worthwhile "buy-spot" during all of the post-war elections — 1948, 1952, 1956, and 1960. Each of these buy-spots occurred between September 27 and October 25. The weakest of the rallies following the September-October buy-spot occurred in 1948; the best of the advances occurred in 1960. The 1952 and 1956 buy-spots produced rallies which carried until the end of the year, but the following year produced trouble.

It is possible that the market turned down during those four years prior to election simply because Wall Street was "protecting itself" against the possibility of the unexpected. Of the four elections, only the 1948 Truman election proved a true surprise. The Kennedy election in 1960 was extremely close, could have gone either way, but the market had been declining since January of 1960, and the reaction was ready to end, regardless of who was elected. In general, this observer is of the opinion that the usual September-October pre-election decline is the market's way of discounting the worst of a possible election surprise. Once the worst is discounted, the market seems to be taken over by the optimists once again.

I have drawn a chart showing the action of the Industrial Average through each of the last elections. The chart has been drawn to arithmetic scale so that action (rather than percentage of movement) is emphasized.

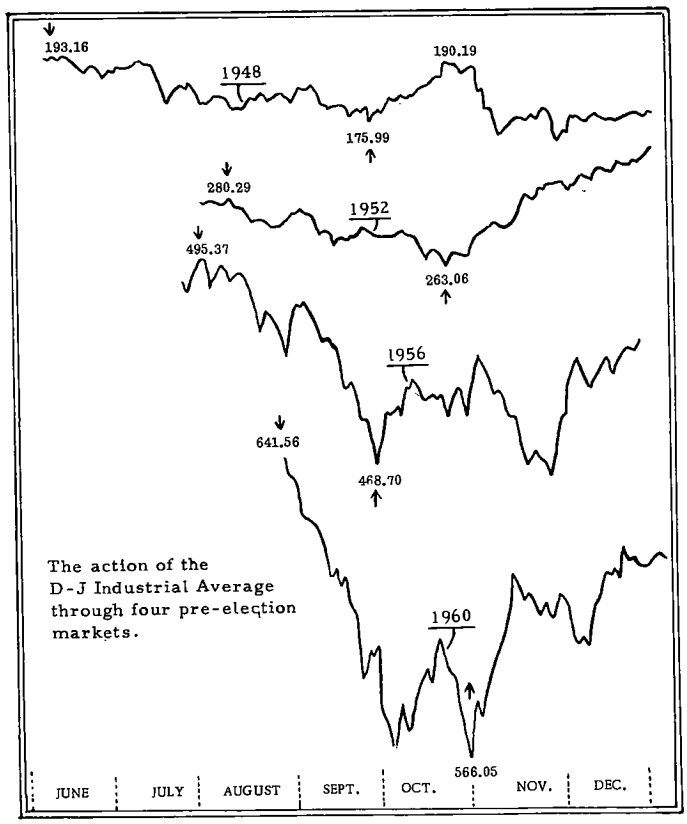
1948: From the peak of 193.16 struck on June 15, the Industrials slipped lazily lower to 175.99 on September 27. With three steady months of decline behind them and the election a matter of weeks away, traders must have considered this a pre-election buy-spot. The market rallied to an October 23 peak of 190.19 — three points below the June 15 high. The average moved sideways for a week, then caved-in on the incredible news of Mr. Truman's election.

1952: Industrials struck a peak on August 11 of 280.89. A long low-volume (about a million shares per day) decline carried to 263.06 on October 22. From this pre-election buy-spot, the Average rallied on increased volume. The advance carried to the end of the year.

1956: Industrials had topped out in April, 1956, and were in the throes of a huge and complicated reaction. From a peak of 520.95 reached on August 2, Industrials sagged to a pre-election buy-spot on October 1 (468.70). By November 5 the senior Average had rallied to 495.37. On the following day the rather obvious outcome of the election was announced: Eisenhower had defeated Stevenson for the second time in four years. A sharp reaction carried Industrials 2 points below the October low, and for the balance of the year the market rallied..

1960: The 1960 election came (as did the 1956 one) within the framework of a major reaction. Industrials struck a peak of 641.56. an extremely sharp decline took Industrials below the much watched 600 level — to 566.05. From this pre-election buy-spot the Industrials rallied irregularly until the end of the year.

To summerize: each of the previous four election markets produced a decline which struck bottom between September 27 and October 24. Each of these declines was followed by a pre-election rally. Following the 1948 and 1956 election news, Industrials promptly



The action of the D-J Industrial Average through four pre-election markets.

dropped below their pre-election lows, then rallied again. The 1952 and 1960 markets remained strong until the end of the year. Based on these four elections, the safest "play" for traders would be to buy on a low reached in the September-October period— then sell the day before the actual election.

TWO SCHOOLS: In the last Letter I discussed the three phases of a bull market. Particular attention was called to the current unprecedented situation — in which a bull market of fifteen years' duration has produced a third (speculative) phase of seven years' duration.

This whole concept of the primary trend is the most fundamental, and perhaps the least understood, of any area of market knowledge. "A primary bull market," wrote the great Dow Theorist Robert Rhea, "is a broad upward movement, interrupted by severe declines or secondary reactions, and averaging longer than two years. During this time, stock prices advance because of a demand created by both investment and speculative buying inspired by anticipated or realized improving business conditions and increased speculative activity." A bull market continues in force until the best that can be seen ahead is fully discounted by the Averages. When the best is finally discounted — the bull market ends. Following the bull market, a primary bear market gets underway. The bear market serves to correct the excesses of the preceding bull market.

It should be stressed that Dow Theorists do not see the "bull market-bear market sequence" as a casual coincidence or an aberration of history which may terminate at any time. They believe that bear markets follow bull markets and bull markets follow bear markets as night follows day, as old age follows youth, as the clearing follows the storm. Obviously, this simple and fundamental approach is direct opposition to the entire "managed economy" approach which finds such wide-apread acceptance and approval today.

"But," retorts the modern economist, "look how long this thing has been going on. We've heard all these classical 'up and down' arguments before, and they're passé. Look how many years have gone by without serious trouble. No I'm afraid that you'll have to admit that we've finally mastered the 'boom-bust cycle'".

To which the Dow Theorist replies: "The bigger the bull market, the greater the odds for a disastrous bear market. Since no tree grows to the sky, and since a bear market will appear when this bull market is over, it is simply a question of how bad the bear market is fated to be. And because a bear market corrects the excesses of the preceding bull market, the higher this thing goes, the more excesses to correct."

So there you have it; either you believe in the inevitability of bull and bear markets or you do not. If you do, then (because of the remarkable duration and extent of the current bull market) you are bound to be somewhat worried about the stock market and the economy over the next few years (just as you might be somewhat optimistic about the future during a bear market that had already lasted three or four years).

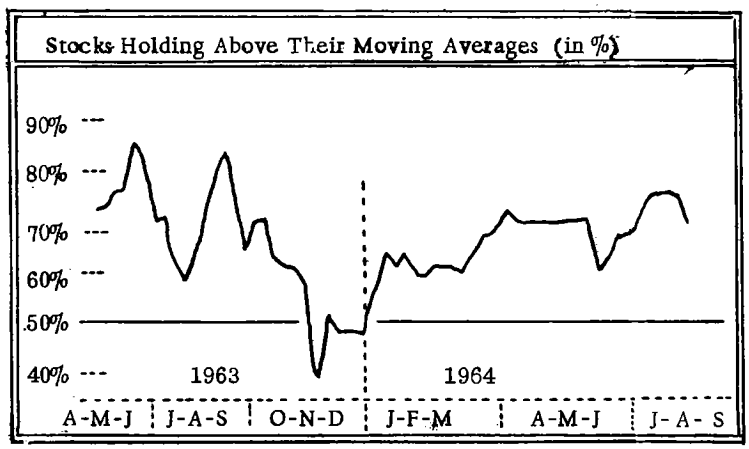
One of the very interesting approaches to this whole bull market concept has been adopted by one particular group of Dow Theorists (it should be remember that just as lawyers may differ about a case but not the law, so Dow Theorists may differ about a bull market but not about the Dow Theory). This group of Dow Theorists reason as follows: Almost all bull markets have ended with typical third phase characteristics of high volume, rampant bullishness, excited moves in low-priced stocks, wide-spread public participation, low yields, etc. The bull market which began in 1949 is the greatest bull market the world has ever seen. It should therefore end with one of the biggest explosions in speculative sentiment that has yet been seen. These Dow Theorists were convinced during 1959 and again in 1961 that they were not seeing rampant speculation of the type which occurred during 1928-29. Moreover, they feel that the current action does not represent the type of speculation that they would expect to see at the final top. They believe that this bull market, regardless of reactions, pseudo-bear markets, even 1962-type crashes, will continue in force until it "blows its top" in a manner similar to 1929.

A second group of Dow Theorists believe that this bull market may end differently. Indeed, they hold that the 1962 crash represented the first major crack in the old bull's hide. They note that two-thirds of the stocks on the N. Y. S. E. are now below highs reached in 1956-63; they note that 10 of the 30 D-J Industrial stocks touched new all-time highs during the past two years; they observe that while the speculation since 1957 might not at any given time have been as intense as that seen in 1929, it has nevertheless lasted three times as long. For these reasons, the second group of Dow Theorists are of the opinion that "it is later than you think".

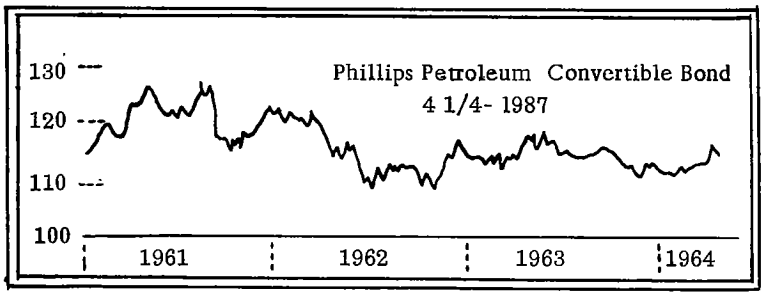
There you have it: one group of Dow Theorists believes that the market is in a massive "topping out" process now, the other group thinks that the top could be perhaps a year away. Both groups agree on one thing — that it is fairly late in the game, and that many individual stocks and groups have already completed their major bull market moves (and have now turned down). This means that the odds for picking "the right" stocks or groups are becoming progressively slimmer. And anyone who has purchased stocks over the past year-and-a-half will verify this observation.

STOCKS: Of 432 representative stocks which are tabulated here weekly, 296 (69%) are now holding above their 30-week (long-term) moving averages, a drop of 6% from the last Letter. This study remains bullish as long as the percentage holds above the critical 50% level (see chart on page 4).

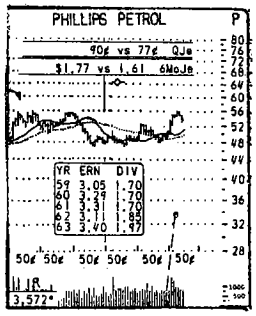
There are now enough stocks in both bullish and bearish trends to back up almost any market viewpoint. The big question is not whether one can come up with a stock which looks "right" for buying or selling short; the question is, will the stock which one chooses move out substantially one way or the other? The fact is that since mid-1963, it has been exceedingly hard to make money in the market. In view of this, I feel that there are four intelligent positions in this market: (1) A long position in a selected number of strong stocks. (2) A long position in a few strong stocks and a limited short position in a few weak stocks. (3) No position at all, while awaiting a possible selling climax and really advantageous buying opportunity.

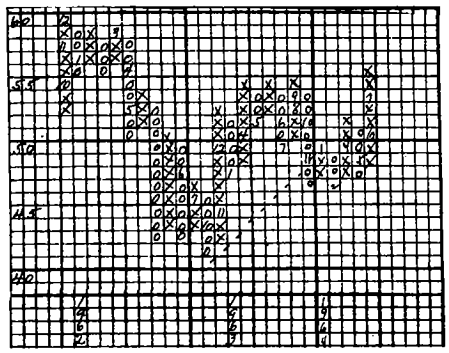


The fourth choice makes particularly good sense at this time — this is a position in convertible bonds. A convertible bond is a debt instrument which may be converted into the common stock of the same company at the option of the holder. A convertible (bond) possesses a "floor" or support level on the downside. This is because a bond has a fixed rate of interest, and at a certain price (forgetting the conversion) it is worth something as a pure bond (selling wholly on a yield basis). During an advancing market, the convertible tends to move with its common stock, and the bond will move in direct ratio with the stock once the bond is "on conversion". Thus if one buys a convertible, and if one does not purchase the bond too far above its "floor" or value as a pure bond, one has a good vehicle for gain if the stock goes up, while one has a defensive position if the stock goes down (since the bond will tend to hold on a yield basis). Another important advantage of convertibles is that commission for purchase and sale are low, running $2.50 per bond.



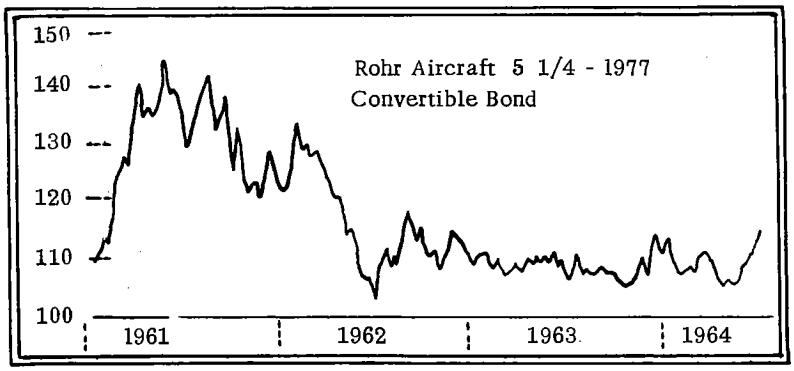
PHILLIPS PETROLEUM (P)



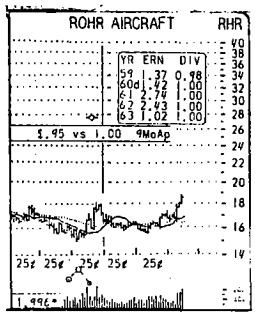


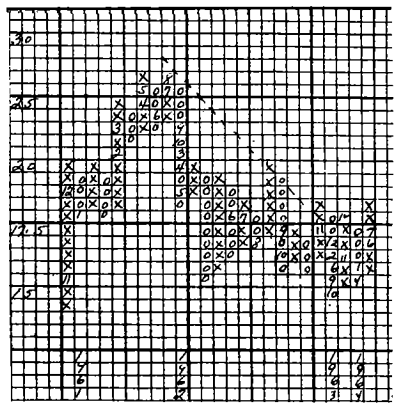
I have included charts of two convertibles which I like at this time. The Phillips Petroleum bond is rated AA (high quality) by Standard & Poor, the Rohr Aircraft is rated BB (lower medium quality).

Each Phillips bond is convertible into Phillips common stock at 50 (in other words each bond is convertible into 20 shares of common). Phillips common is now around 55, and the bond is therefore "on conversion" (the price of the common is now above 50, which necessarily pushes the bond above 1000). Since the bond is now selling at 117 (actually $1,170, but bonds are always quoted in hundreds), the buyer is paying a 9 point premium (above conversion price) for the privilege of owning the bond. Note (on chart) that this bond never sold under 108, even during 1962 when the common went below 45. At present the common of Phillips is bullish, the point & figure chart showing a good breakout at 56, while the weekly shows a bullish relationship between the stock and its moving averages.



ROHR CORP. (RHR)

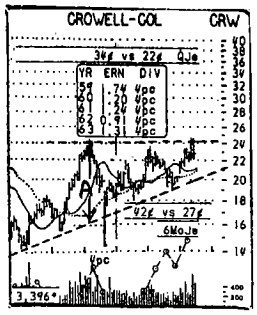




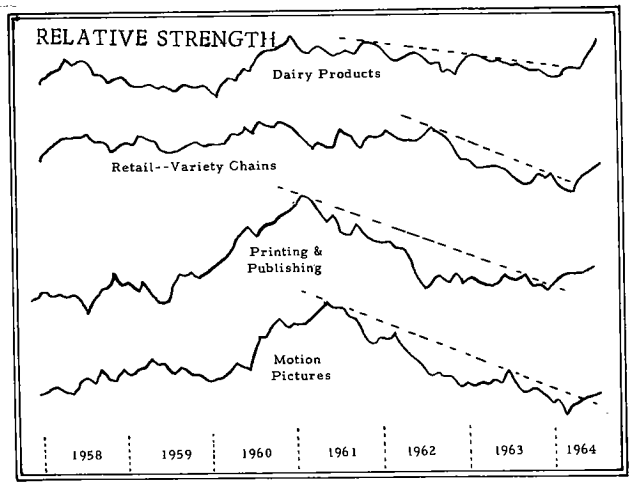
The Rohr bond yields 4.6% at its current price; it goes on conversion when the stock reaches 18 1/2 (where it now is), and each bond is convertible into 54 shares of stock. The bond is now selling at 115, which means that the buyer is paying a 15 point premium. This bond is mainly interesting because the common of Rohr has now turned bullish and will show a strong "breakout" if the stock goes to 19. In

the good old days of 1961 (when San Diego and Rohr, which is a San Diego company, were both booming) the common stock of Rohr sold as high as 27 and the bond sold as high 145. But note that even in 1963 when the stock sold as low as 15, the bonds never cracked 105. The point & figure chart shows Rohr reversing its bearish trendline and now in line for a bullish breakout at 19. The small bar-line chart shows Rohr holding well above its moving averages.

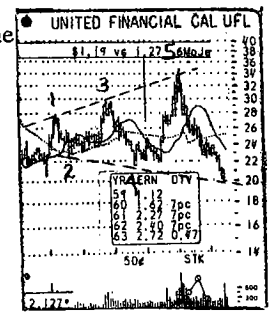
Conclusion: Phillips and Rohr convertibles are interesting speculations here. Commissions would be low compared to cost of any common stock purchases. Safety factor — sell the Phillips bonds if the stock breaks below 52; sell the Rohr bonds if the common goes below 17.

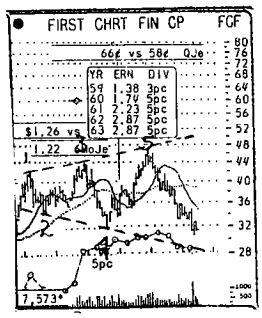


RELATIVE STRENGTH: Four groups showing reversals to the upside in their relative market performances (relative strength or R. S.) are shown on the chart. The Dairy group is fairly defensive and most of the stocks here are fully priced (Foremost is the most interesting speculation here). In the variety chain group I have already recommended W. T. Grant, and I feel this is still in a buy-zone. In the Motion Picture group I have recommended MGM which is now resting after a powerful breakout. In the publishing group I am now calling attention to Crowell-Collier. This stock is showing improved earnings and has been in the process of forming a giant ascending triangle (suggesting accumulation on a rising scale starting from 14 — see chart). A breakout above 24 in CRW could set the stage for a rise to the upper 30's, according to the "measurement" of the triangle (the measurement of the triangle is the vertical line "A" extended the same distance from the top or horizontal part of the triangle).



STOCK NOTES: The force of the "broadening top" pattern is beautifully illustrated in two current weekly charts, United Financial and First Charter Financial. Readers were warned about the S & L stocks in previous Letters, and in these two charts we see the typical collapse from the fifth reversal point of the broadening formation. The action illustrated here explains why the writer is nervous about the current pattern (chart 3, page 1) in the Industrial Average.





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Motorola is one of the weaker looking stocks on the Board. Its R. S. line has turned down and the stock has formed a bearish descending triangle in the vicinity of its 1961 top. For those who want protection on the downside, MOT can be shorted at the market with a stop at 97. Two other outstandingly weak stocks are Kimberly-Clark and Olin Mathieson.

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National Lead (recommended in Letter 259) broke out above 80 this week and is again recommended as one of the best looking quality stocks.

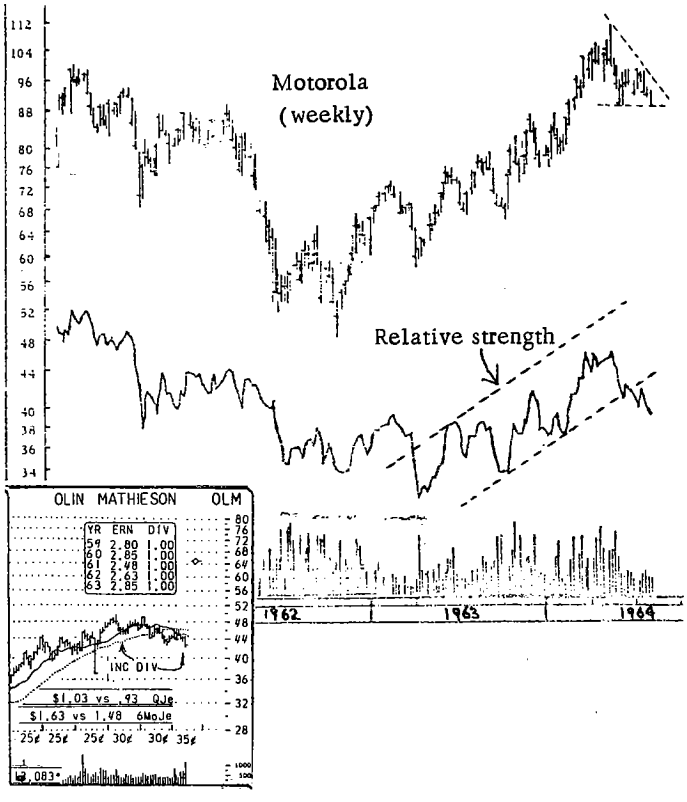

Chart of Motorola courtesy of Traders Research, 1431 Pearl Avenue, Alton, Illinois 62003. Point & Figure charts courtesy of Chartcraft, Larchmont, New York. Chart #3 and small weekly charts (with moving averages) courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas. Group relative strength charts courtesy of Ray * Signals, 141 Broadway, New York 6, New York.